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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No. 436

MARIO MORANO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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No. 436

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, Fred M. Vinson, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Third Circuit, entered June 15, 1949, rehearing denied August 16, 1949, affirming the judgment of the Tax Court.

Opinions Below

The memorandum opinion of the Tax Court (R. 122-130) is reported in ¶ 48, 125 P-H Memo TC. The opinion of the Court of Appeals (R. 137) is reported in 175 Fed. (2d) 555.

Jurisdiction

The judgment of the Court of Appeals was entered on June 15, 1949, rehearing denied August 16, 1949. The jurisdiction of this Court is invoked under 25 U. S. C. 1254.

Statement

On March 22, 1943, before the Supreme Court had defined the term "partnership" under the Internal Revenue Law, petitioner and his wife, together with their two children, organized a family partnership in a machine shop business.[1] The machine shop business had theretofore been carried on in corporate form, its capital stock being divided among the members of the family (R. 111).[2] Upon forming the partnership the members of the family received shares therein, corresponding to their previous holding of corporate stock (R. 124).

Petitioner, his wife and children began to work for the business shortly after its organization as a corporation in 1941, and thereafter all continued to render important services for the business. In 1942 the corporation experienced financial difficulty and receivership proceedings were instituted against it in the Court of Chancery of New Jersey by a stockholder. Fortunately, there was the will and determination by the family to carry on, together with an impelling incentive provided by petitioner in buying out the interests of the dissident stockholders, which amounted to two-thirds of the corporate stock, and causing them to

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[1] The Articles of Limited Partnership dated March 22, 1943, were filed and recorded with the Clerk of Essex County, New Jersey, on April 1, 1943, pursuant to the Revised Statutes of New Jersey, 42:2-1 to 42:2-30 inclusive. By its terms the arrangement was to expire December 31, 1953, or prior thereto upon mutual consent of the partners (R. 114).

[2] The corporate stock consisted of 40 shares, of which the petitioner held 13 shares, petitioner's wife held 13 shares, their two children held 6½ shares each, and one qualifying share was held by an attorney (R. 111).

transfer and assign one-third of the stock directly to his wife[3] and one-third to his two children.[4] Petitioner did this in recognition of the services being performed by the family (R. 110), almost one year before any partnership arrangement was contemplated. The book value of the stock transfer to the wife was $1300.00 and the book value of the stock transfer to each child was $650.00 (R. 35). In terms of actual market value the stock was practically worthless. In this posture of events, the collective mind of the family was not meditating the possibility of tax avoidance; they were simply concerned with keeping the corporate ship afloat. With joint resolve and singleness of purpose, this was accomplished. The combined efforts of each member of the family in contributing the utmost, in time, skill and effort, finally propelled the ship to its haven (R. 111). Petitioner took the helm and the family manned the oars. Petitioner worked as the set-up man; Salvatore, the son, worked in the shop, while Theresa, the wife, and Rosemarie, the daughter, worked at the office and at the shop bench installed in the basement of their home. Theresa and Rosemarie worked daily, from ten to twelve hours per day, while Salvatore acted as expediter and assistant to his father, working on any of the machines to take the place of workmen who did not show up.

Subsequently, upon the formation of the family partnership in March, 1943, Articles of Limited Partnership were executed and recorded, which provided that the petitioner would be the only general partner, and his wife and two

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[3] 13 Shares were transferred and assigned to Theresa Morano, petitioner's wife, on April 11, 1942 (R. 110) by Edward L. Krebs (R. 37).

[4] Insofar as the two children were minors, the transfer and assignment of stock to the two children was accomplished as follows: 6½ shares were transferred and assigned to Theresa Morano, trustee for Salvatore Morano (the son) and another 6½ shares were transferred and assigned to Theresa Morano, trustee for Rosemarie (the daughter), on June 26, 1942 (R. 110) by Joseph Liloia (R. 38).

children would be the three limited partners. The assets of the corporation were then liquidated and each member of the family contributed his or her respective liquidated share to the partnership.[5]

The Commissioner of Internal Revenue contended that the partnership should not be recognized for tax purposes and that the entire income from the partnership should be taxed to the petitioner. A determination was then made by him of deficiencies in petitioner's income tax for 1943 and 1944 in the amounts of $17,103.04 and $12,118.18 respectively.

Petitioner sought a redetermination of these deficiencies in the Tax Court of the United States. On the trial of the issues therein, the uncontroverted evidence adduced on behalf of the petitioner proved beyond equivocation that petitioner's wife and children performed vital services, services which definitely had contributed to the success of the business, both as a corporation and as a partnership. The Commissioner of Internal Revenue showed as part of his own case that petitioner's wife and children worked daily from ten to twelve hours per day (R. 121), and he further stipulated in open court as follows (R. 111):

> "It was the *intent and purpose* of the group to establish a family business by their combined efforts, each member of the family contributing their time, skill and

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[5] The agreement recited:

Each limited partner shall contribute the amount set opposite their respective names, being a claim and interest in certain assets consisting of cash and fixed assets, whose value shall have been determined mutually by all partners, and evidenced by a bill of sale and assignment of the same to the partnership:

Limited Partner	Value of Assets Contributed
Theresa Morano	$5,000.00
Theresa Morano, trustee for Sal Morano	2,500.00
Theresa Morano, trustee for Rosemarie Morano	2,500.00

effort towards the growth of the business, conserving and accumulating the assets and funds for future expansions."

Notwithstanding this uncontradicted proof as to the contributions of capital and the rendition of vital services by the limited partners, on June 30, 1948, the Tax Court decided that there were deficiencies in petitioner's income tax for the years 1943 and 1944, in the amounts of $17,103.04 and $12,118.18 respectively. The opinion of the Tax Court was predicated primarily on its interpretation of *Commissioner* vs. *Tower,* 327 U. S. 280, and *Lusthaus* vs. *Commissioner,* 327 U. S. 293, the Tax Court holding that there was no contribution of capital *originating with the family,* nor the performance of managerial or vital additional services, such as would justify a recognition for tax purposes of their status as partners. The erroneous rule of thumb [6] of "original capital" and "vital services" as the two essentials of [7] a family partnership was applied. Moreover, the Tax Court, continuing to strain the words of the Tower opinion, placed further restraints and qualifications on the terms "original capital" and "vital services" as used therein. First it held that since petitioner was the fountainhead from which the funds flowed for the transfers of

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[6] The "rule of thumb" denounced by the decision of this Court in *Commissioner* v. *Culbertson,* 337 U. S. 733, was the paramount consideration of the Tax Court, see (R. 128): "This is a family partnership case in which petitioner claims validity of the arrangement for tax purposes on the grounds that his wife and children contributed services and capital originating with them. *Commissioner* v. *Tower,* 327 U. S. 280; *Lusthaus* v. *Commissioner,* 327 U. S. 293." Petitioner, on the other hand, contended, both in the Tax Court and the Court of Appeals, that the *Tower* and *Lusthaus* cases announced no such "rule of thumb" and in his briefs argued that the Tax Court completely ignored the one absolutely essential determination which it was required to make in accordance with the law, namely, did these parties really and truly intend to carry on this business as a partnership.

[7] The Tax Court spoke in terms of original capital *and* vital services.

corporate stock[8] to the members of the family, the liquidated value of this stock when eventually contributed by the members of the family as their respective shares to the partnership would not be recognized as a contribution to the partnership of capital originating with them. The fact that petitioner had never owned the stock originally, but had only supplied the funds for a transfer and assignment of this stock from the original holders thereof to the members of the family (R. 37, 38), almost one year before a partnership was contemplated, did not alter the position of the Tax Court in its interpretation of "original capital." The Tax Court refused to adopt the interpretation that capital originating with them, meant capital originating with them at the formation of the partnership, as explained by the decision of this Court in *Commissioner* v. *Culbertson*, 337 U. S. 733. Secondly, the Tax Court held that the services contemplated by the *Tower* case must be of a managerial type, a further qualification as to the type of services which was not compelled or made controlling by the *Tower* case. It also failed to consider the true distinction between a general and limited partner, and the infirmities inherent in the very definition of the term "limited."[9] Justice Black, granted reality to this distinction when he spoke for the Court in the *Tower* case, 327 U. S. at 290, as follows:

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[8] The Tax Court found that these transfers were made and the Commissioner of Internal Revenue so stipulated. These transfers have never been challenged. The law on this subject is established. See *Marshall* v. *Commissioner*, 57 Fed. (2d) 633, certiorari denied, 287 U. S. 621, *Bardach* v. *Commissioner*, 90 Fed. (2d) 323, *Dulin* v. *Commissioner*, 70 Fed. (2d) 828. See also comments of Randolph E. Paul, tax advisor to the Secretary of the Treasury, in Federal Estate and Gift Taxation, Volume 2, at page 1071.

[9] Petitioner was the only general partner, and as such, by the express provisions of the Articles of Limited Partnership, was placed in a position legally to direct the management and control the business.

"A wife may become a general or limited partner with her husband."

In what was conceded by the Tax Court to be a case almost identical with the present one, i.e., *Lawton* v. *Commissioner*, 164 Fed. (2d) 380, which the Tax Court refused to follow, adopting its own reversed decision in *Howard B. Lawton*, 6 T. C. 1093,[10] as the one correctly interpreting the *Tower* case, it stated:

"It is true that upon petition for review the Circuit Court of Appeals drew different inferences of fact from the record and reversed our decision (C. C. A. 6th Cir.) 164 Fed. (2d) 380. With the greatest deference, however, we are constrained to regard the earlier decision as correct and to continue to follow it."

On September 20, 1948 petitioner filed a petition to review the decision of the Tax Court in the Court of Appeals for the Third Circuit. In a per curiam opinion, the Court of Appeals affirmed the Tax Court on June 15, 1949, holding that the decision of the Tax Court was not "clearly erroneous."

On July 30, 1949, petitioner filed a petition for rehearing relying chiefly upon the recent decision of the Supreme Court in *Commissioner* v. *Culbertson*, 337 U. S. 733, decided June 27, 1949, twelve days after the judgment was entered herein. On August 16, 1949, the petition for rehearing was denied.

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[10] Referring to the reversed decision of Howard B. Lawton, 6 T.C. 1093, the Tax Court said: "In a case which petitioner described as 'almost identical' we held that the family partnership lacked reality for tax purposes where the wife's interest in the predecessor corporation was obtained by a gift from the husband and on account of uncompensated services, and the children were included by gifts from both parents. Howard B. Lawton, 6 T.C. 1093."

Question Presented

Whether the Court below departed from the decisions of this Court in *Commissioner* v. *Tower*, 327 U. S. 280, *Lusthaus* v. *Commissioner*, 327 U. S. 293, *Commissioner* v. *Sunnen*, 333 U. S. 591, and *Commissioner* v. *Culbertson*, 337 U. S. 733, in affirming the Tax Court's decision that business income attributed by petitioner to his wife and two children as "limited partners" was includible in taxpayer's gross income as defined in Section 22 (a) of the Internal Revenue Code.

Statutes Involved

These are set forth in the Appendix, *infra*, pp. 31-32.

Specification of Errors to Be Urged

The Court of Appeals erred,

(1) In holding, contrary to the decisions of this Court in *Commissioner* v. *Tower*, 327 U. S. 280, *Lusthaus* v. *Commissioner*, 327 U. S. 293, and *Commissioner* v. *Culbertson*, 337 U. S. 733, that the partnership formed between petitioner and his family would not be recognized for tax purposes, irrespective of the fact that the family had made contributions to the partnership of capital originating with them, and had performed vital additional services.

(2) In holding, contrary to the decision of this Court in *Commissioner* v. *Culbertson, (supra)*, *Commissioner* v. *Tower, (supra)*, and *Lusthaus* v. *Commissioner, (supra)*, that the partnership formed between petitioner and his family would not be recognized for tax purposes irrespective of the uncontroverted evidence that the petitioner and his family really and truly intended to join together as partners, and irrespective of the written stipulation made

in Court by the Commissioner of Internal Revenue as follows:

> "It was the intent and purpose of the group to establish a family business by their combined efforts, each member of the family contributing their time, skill and effort towards the growth of the business, conserving and accumulating the assets and funds for future expansion."

(3) In holding, contrary to the decision of this Court in *Blair* v. *Commissioner*, 300 U. S. 5, that the income arising from property donated outright and in good faith to a member of the family will be taxed to the donor and not the donee, and in holding, contrary to the decisions of this Court in *Lucas* v. *Earl*, 281 U. S. 111, *Burnet* v. *Leininger*, 285 U. S. 136, *Helvering* v. *Clifford*, 309 U. S. 331, *Helvering* v. *Horst*, 311 U. S. 112, *Helvering* v. *Eubank*, 311 U. S. 122, *Harrison* v. *Schaffner*, 312 U. S. 579, and *Commissioner* v. *Sunnen*, 333 U. S. 591, that the income from the partnership was chargeable for tax purposes solely to petitioner, irrespective of the fact that the family had contributed capital and services to create this income, which income in turn, is now being taxed solely to petitioner as the one who earned it.

(4) In sanctioning the practice of the Tax Court, in predicating its decision in the present case on the authority of its opinion in *Howard B. Lawton*, 6 T. C. 1093, an identical case, irrespective of the fact that the case was reversed by the Court of Appeals for the Sixth Circuit in *Lawton* v. *Commissioner*, 164 Fed. (2d) 380.

(5) In failing to afford petitioner the proper scope of review, where the Tax Court, in determining the ultimate fact or the "reality" of the partnership had proceeded upon erroneous principles of law.

(6) In affirming the Tax Court.

Reasons Relied On for Allowance of Writ

1. The decision of the Court of Appeals for the Third Circuit in the present case swings the pendulum of tax decisions in an ever widening arc in the opposite direction of that which was originally contemplated by the Internal Revenue Law. The decision ignores sections 181 and 182 of the Internal Revenue Code and extends section 22a far beyond its meaning.[11] The decision ignores and is in conflict with all the decisions rendered by this Court on the question of family partnership, and stands in flagrant disregard of sound principles of taxation. This case represents a challenge by the Commissioner of Internal Revenue to these principles, and if he is permitted to prevail, he will have secured from this Court, what he was bereft of in the Legislature. *Commissioner* v. *Tower,* 327 U. S. 280, *Lusthaus* v. *Commissioner,* 327 U. S. 293, and *Commissioner* v. *Culbertson,* 337 U. S. 733, announce no such doctrine, but stand as a bulwark for the protection of these principles in this case. The Court of Appeals in affirming the Tax Court held that the assets derived from the liquidation of stock held by the members of the family in a predecessor corporation and contributed to the partnership as their respective shares therein, was not a contribution to the partnership of capital originating with them. Thus, in effect, the Court has decided that although the members of the family would be recognized as the owners of the same business when conducted in corporate form, such ownership would revert to the petitioner when the business is conducted in a partnership form. Such a proposition is totally in conflict with *Blair* v. *Commissioner,* 300 U. S. 5, to the effect that where real property or personal property, tangible or intangible, is donated outright and in good faith to a member of the family, the income thereafter arising will be

[11] 26 U.S.C. 1946 ed., sections 181, 182, 22(a).

taxed to the donee and not to the donor. It makes no difference whether the property is corporate stock, an office building, or a horse.

2. The decision of the Court of Appeals is in direct and challenging conflict with the case of *Lawton* v. *Commissioner*, 164 Fed. (2d) 380, a case conceded by the Court to be almost identical. The *Lawton* case held that the assets derived from the liquidation of stock in a predecessor corporation by the members of the family and contributed by them to the partnership, was a contribution to the partnership of capital originating with them.[12] The Tax Court in the present case, refused to follow the *Lawton* case, *(supra)*, and chose instead to follow its own reversed decision therein as the correct one to follow. The *Lawton* case, *(supra)*, has never been challenged by the Commissioner of Internal Revenue and is in accord with the decisions of this Court in *Commissioner* v. *Tower, (supra), Lusthaus* v. *Commissioner, (supra),* and *Culbertson* v. *Commissioner, (supra).*

3. The decision of the Court of Appeals conflicts with the decision of this Court in *Commissioner* v. *Culbertson*, 337 U. S. 733, in that the ultimate question of fact, or the reality of the partnership, was not decided as a fact, but was predicated upon erroneous premises of law. The Tax Court had applied the wrong tests and the wrong emphasis on subsidiary facts, and had read the cases of *Commissioner* v. *Tower*, 327 U. S. 280, and *Lusthaus* v. *Commissioner*, 327 U. S. 293, as setting out two essential tests of partnership for income tax purposes; that each partner contribute

[12] The Tax Court had originally resolved the question in favor of recognizing the partnership. See S. E. Boozer, CCH TC Dec. 16,008 (M) (1947) to the effect that if the husband makes a gift to his wife before the partnership was contemplated, and if the wife subsequently contributes the gift as her partnership capital, the wife's partnership interest is recognized for tax purposes.

to the partnership either vital services or capital originating with him. This Court held in the *Culbertson* case that the true test is: Did the parties really and truly intend to form a partnership?

The lower court misplaced its emphasis on "original capital" and "vital services" as a rule of thumb. It compounded this error by applying erroneous rules of law to an otherwise erroneous rule of thumb, both in its interpretation of "original capital" and in its interpretation of "vital services", when applied to a limited partnership.

4. The decision of the Court of Appeals is in conflict with the decision of this Court in *Blair* v. *Commissioner*, which held that the donee, and not the donor, is taxable for income from property donated outright and in good faith, and this conflict extends to the *Earl-Clifford-Horst* [13] line of cases of this Court, in *Lucas* v. *Earl*, 281 U. S. 111, *Burnet* v. *Leininger*, 285 U. S. 136, *Helvering* v. *Clifford*, 309 U. S. 331, *Helvering* v. *Horst*, 311 U. S. 112, *Helvering* v. *Eubank*, 311 U. S. 122, *Harrison* v. *Schaffner*, 312 U. S. 579 and *Commissioner* v. *Sunnen*, 333 U. S. 591. The lower court proceeded on the assignment of income theory, failing to consider the transgression on the rationale of the *Earl-Clifford-Horst* line of cases, that income must be taxed to those who earn it. The Commissioner of Internal Revenue seeks to charge the entire income from the partnership to petitioner, and not to the respective members of the family who helped to earn the same by virtue of their contributions of capital and property. What the Commissioner of Internal Revenue is really seeking to establish is that a property interest in a partnership be treated differently from any other type of property interest. The Internal Revenue Code espouses no such principle, and cer-

[13] *Lucas* v. *Earl*, 281 U. S. 111, *Helvering* v. *Clifford*, 309 U. S. 331, *Helvering* v. *Horst*, 311 U. S. 112.

tainly, in the absence of some Congressional expression, no court should assume the authority to lay down such a rule.

The lower court, in disregarding the decision of this Court in *Blair* v. *Commissioner (supra)* and the *Earl-Clifford-Horst* line of cases, went one step further, and in sharp conflict with the decisions of other Courts of Appeals,[14] held that the important services performed by the family, services which averaged ten to twelve hours per day, would also be disregarded so that the entire income of the partnership would be taxed to the petitioner as the one who earned it.[15]

5. The decision of the Court of Appeals conflicts with the decisions of this Court and other Courts of Appeals in that the Court of Appeals arbitrarily set aside the vested rights of the parties, as contained in the agreement of partnership, and held the petitioner chargeable for taxes on income to which he had neither a contractual or legal right.[16] In *Woosley* v. *Commissioner,* 168 Fed. (2d) 330, the Court of

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[14] *Singletary* v. *Commissioner,* 155 Fed. (2d) 207, (5th Cir.), *Wilson* v. *Commissioner,* 161 Fed. (2d) 661, (7th Cir.), *Weizer* v. *Commissioner,* 165 Fed. (2d) 772, (6th Cir.), *Hartz* v. *Commissioner,* 170 Fed. (2d) 313, (8th Cir.), certiorari denied 337 U. S. 959, *Walsh* v. *Commissioner,* 170 Fed. (2d) 535, (8th Cir.), *Kent* v. *Commissioner,* 170 Fed. (2d) 131, (6th Cir.), *Graber* v. *Commissioner,* 171 Fed. (2d) 32, (10th Cir.), *Le Sage* v. *Commissioner,* CCH 49-2, USTC ¶ 9244, (5th Cir.), and *Wenig* v. *Commissioner,* CCH 49-2 USTC ¶ 9348, (Dist. of Col.).

[15] In the present case the Tax Court in making allocations of the reasonable value of the services performed by the family, was guided by the amounts the various members of the partnership had withdrawn from their share of the profits, and the record conclusively establishes that the Tax Court used the amounts withdrawn, or these drawing accounts, as the correct measure of the worth of the respective individual partners. Thus, in spite of the fact that considerable service was performed by all the members of the family in the partnership, the Tax Court found that during the taxable year 1943, the services of the wife were worth $18.00 per week, the services of the daughter were worth $2.00 per week, and the services of the son were both absolutely nothing, bearing in mind that all were working full time.

[16] The legal error in such procedure is also noted in *Kent* v. *Commis-*

Appeals for the Sixth Circuit held that the Tax Court erred as a matter of law in making the allocations it did contrary to the express provisions of the Articles of Partnership. In *Canfield* v. *Commissioner*, 168 Fed. (2d) 907, the Court of Appeals held that the Tax Court had no lawful right for income tax purposes to make a new contract for the parties. In *Walsh* v. *Commissioner*, 170 Fed. (2d) 535, the Court of Appeals for the Eighth Circuit held that the taxpayer is not required to pay taxes upon income to which he has neither a contractual or legal right.

6. The decision of the Court of Appeals is in conflict with the decisions of this Court and other Courts of Appeals in proceeding upon erroneous principles of law, and in not determining the ultimate fact of the case, *i.e.*, the reality of the partnership, as a fact, but proceeded only to find out whether the subsidiary facts of the case were such as to bring the partnership within an incorrect principle of law.[17] In such a situation the court should have remanded the case to the trial court with directions to the trial court to determine the facts in the light of the proper legal principles,[18] or, in the alternative, make its own findings of

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sioner, 170 Fed. (2d) 131 at 136 and is discussed by Robinson "The allocation Theory in Family Partnership Cases," 25 Taxes 963.

See also *Park* v. *Cullum*, 132 U. S. 539 to the effect that the rule does not change by the fact that one partner's contribution of time and skill is greater than that of the other.

[17] In *Helvering* v. *American Dental Co.*, 318 U. S. 322 at 330: "We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22 (b) (3) exempts gifts. This does not leave the Tax Court free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift." See also *Walsh* v. *Commissioner*, 170 Fed. (2d) 535 which reversed the Tax Court, for an erroneous application of the law to the facts, and upheld the partnership.

[18] This procedure was followed by the Court of Appeals for the Fifth Circuit in the case of *Ginsburg* v. *Commissioner* CCH 49-2 USTC ¶ 9396, which on rehearing reversed its prior decision in CCH 49-2 USTC ¶ 9381, and remanded the case to the District Court for further consideration

fact. The Court of Appeals should not have affirmed on the basis that the Tax Court was not "clearly erroneous".

7. The decision of the court below reflects a marked departure, and stands in sharp contrast with the current development of the law. By the Internal Revenue Act of 1948 Congress recognized and granted stability to partnerships involving husbands and wives. The resolutions and statement of the American Bar Association have denounced the rules being applied by the Tax Court as completely unjustified.[19] The Ways and Means Committee approved and the House of Representatives passed provisions which would eliminate retroactively the Tax Court's rule of thumb. It is interesting to note the explanation of the Ways and Means Committee:

> "Legislation on family partnerships is deemed necessary because the lower courts and those administering the tax laws have taken the position that the Supreme Court's decision in the Tower and Lusthaus cases in 1946 limits the recognition of partner status in a family partnership to those who have contributed capital originating with themselves or who have performed vital additional services. At present no question is raised, however, if a husband makes a completed gift to his wife of stock in a family corporation. The gift is recognized, and the dividends paid on the stock are taxed as income to the wife. Nor would the courts or the administrative officials refuse to recognize for income tax purposes the income of a wife from rental property received as a bona fide gift from her husband.

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of the evidence and for application of the legal principles announced in *Commissioner* v. *Culbertson*, 337 U. S. 733.

This procedure was also followed in the Court of Appeals for the Ninth Circuit in the cases of *Harris* v. *Commissioner*, 175 Fed. (2d) 444, and *Trepte* v. *Commissioner*, 175 Fed. (2d) 444. See also the recent case of *Seabrook* v. *Commissioner*, CCH 49-2 USTC ¶ 9360.

[19] See Hearings Before Committee on Ways and Means on Revenue Revisions, 1947-48, 80th Cong., 1st Sess. (1947): 3344-46, 3360. See also 3199-3200, 967-969, 898, 903, 939-940, 3599.

> "The bill removes this discrimination with respect to the current and future years and also for open years back to 1941" (H. Rep. 2087, 80th Cong., 2d Sess., p. 10).

Contrary to the above statement, a question has now been raised in the present case as to whether a husband can make a completed gift to his wife and children of stock in a family corporation. By indirection, the court below is whittling away the sounder body of the law in other branches. The encroachment is by way of special definition and rule. It is this encroachment which breeds the confusion.

Debate on the floor of the Senate has also shown a general disapproval of the position which the Commissioner and the Tax Court have taken.[20]

The Court below approached the problem of the transfers of corporate stock to petitioner's wife and children as laying the groundwork for the subsequent formation of a family partnership. Such an approach indicates an extreme anxiety, on the part of the Tax Court, to favor the Commissioner of Internal Revenue and disregard the substantive rights of the taxpayer. Can petitioner be so charged? Can he be charged with laying the groundwork for the sub-

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[20] Senator George, Chairman of the Senate Finance Committee, stated:

> "The Treasury has very vigorously pushed the cases against the so-called family partnerships. I think, and I have said so to the Treasury, and I have said so openly in the hearings in the Finance Committee, that they have gone entirely too far. . . . If the husband makes money and pays all the taxes due upon that money, and if after having paid his taxes he wishes to give the wife an interest in a partnership business or give her money which she puts into that partnership business, there should not be laid down in those cases the narrow test which our courts, I regret to say, have recognized, to wit, whether the wife actually contributed anything by way of work or by way of attention or by way of management of the business. That ought not to have been the test. 93 Cong. Rec. at 6071 (May 28, 1947.)"

See also 93 Cong. Rec. 5987, 5988 (May 27, 1947); 93 Cong. Rec. 6069, 6070 (May 28, 1947).

sequent formation of a family partnership in 1942 and 1943 when he would have had to recognize the principle of law promulgated in *Commissioner* v. *Tower*, (*supra*), decided four years later in 1946? Petitioner feels it is unreasonable to assume such omniscience on the part of a layman, when many lawyers and courts could not foresee such a decision.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted,

MARIO MORANO.

CARL ABRUZZESE,
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Attorneys for and of Counsel With Petitioner.

October, 1949.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No. 436

MARIO MORANO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Argument

POINT I

Petitioner's position is set forth adequately, we think, in the petition for certiorari. Petitioner contends that the lower court erred in requiring him to pay taxes on income to which he had neither a contractual or legal right. There is no authority for such a proposition either in the Internal Revenue Code or the decisions of this Court.

The decision of the lower court disallowing for tax purposes the interests in the limited partnership owned by petitioner's wife and children is predicated on its interpretation of the law of the *Tower* case. The Tax Court relied

on the following paragraph from the decision of the *Tower* case and seized upon this language as a rigid formula to be applied in the *Morano* case.

> (p. 290). If she (meaning the wife) either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things, she may be a partner as contemplated by 26 U. S. C. No. 181, 182. * * * But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws (Parentheses supplied).

From a reading of the decision of the Tax Court, it is obvious that the Tax Court believed that the mandate of the Tower case required it to base its decision upon the two points mentioned in the language above: 1. That petitioner's wife and children did not contribute any capital to the limited partnership originating with them; 2. That they did not "contribute to the control and management of the business, or otherwise perform vital additional services". The Tax Court concluded that these two requisites constituted the rationale of the *Tower* case and that those tests constituted a mandate that if those elements were not present it was powerless to recognize the partnership. Thus, while the *Tower* and *Lusthaus* cases applied to "family partnerships", the salutary rule that form could be disregarded in the search for substance or reality, the anomalous result of the Tax Court's decision is that it exalts form at the expense of substance. Among other things, this means that the Tax Court has completely reversed its reasoning and its attitude on "family partnerships" in this

case; originally the Court insisted that it must look at the realities of each case and not the mere outer cloak of legal dress; that substance and not form controlled. It has in the past paid fervent devotion to Mr. Justice Holmes' admonition in *Lucas* v. *Earl,* (1930), 281 U. S. 111, not to determine these cases on "attenuated subtleties" and it has seen to it that "anticipatory arrangements and contracts however skillfully devised" were not used to adorn an otherwise invalid partnership with the appearance of legal respectability. Now, however, the Tax Court has completely reversed itself and has interpreted the language of the Supreme Court in the Tower opinion just quoted as a mandate to apply a rigid formula to "family partnerships" without the slightest regard to the substance and reality of the situation.

The paragraph cited above from the *Tower* case on which the Tax Court placed so much stress in deciding the present case is dicta, and must be read only in the light of the facts of the *Tower* case. Mr. Justice Black had reached his decision, had announced the law of the case, and then in rationalizing the decision of the Court used the language above set forth as some reasons why the Court sustained the Tax Court in holding that the partnership was a sham. This Court had already determined that from the facts the parties had not "really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."

A careful reading of the above language from the *Tower* case does not justify the Tax Court's position in using it as a rigid formula for deciding "family partnership" cases. The Supreme Court said (p. 290), "If she either invests capital originating with her * * * she may be a partner * * * * * * where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into con-

sideration in determining whether the partnership is real within the meaning of the federal revenue laws." And the Supreme Court earlier in its opinion used this significant language, (p. 290): "Of course, the question of legal ownership of the capital contributed by a wife will frequently throw light on the broader question of whether an alleged partnership is real or pretended."

The Tax Court in deciding that the limited partnership was a sham gave no consideration to the question of the intention of the parties as evidenced by their conduct over the years. Yet, the Supreme Court in the *Tower* case held, and this is the law of the case, "And their intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions'."

The Tax Court completely ignored the one absolutely essential determination which it was required to make in accordance with the law; namely, did these parties really and truly intend to carry on this business as a partnership. Had the Court applied the test of the true intention of the parties, they would have considered the following factors: 1. That all the members of the family contributed many years of vital service to the business, from 1942 onward, irrespective of its legal entity, as a corporation or partnership. 2. That the ownership of the business was divided among the family long before a limited partnership was contemplated. 3. That the members of the family entered into a limited partnership agreement legal and binding upon them in accordance with New Jersey Law, whereby they became liable for the losses to the extent of their capital contributions and were entitled to share in the profits of the business. 4. That the members of the family held themselves out to the public as a limited partnership; they informed their suppliers and customers that a limited partnership had been created and made the neces-

sary changes in their banking and credit facilities. 5. That the limited partnership agreement, although negatively phrased authorized any of the parties thereto as follows (R. 116): "None of the parties hereto shall incur obligations in the name of the partnership, or pay out of the partnership funds, or transfer partnership property except in connection with the partnership business"; they signed war contracts as subcontractors for many departments of the Federal Government and were so recognized by those governmental agencies. 6. That all the members of the family continued to work and render vital services for the limited partnership during all of the taxable years. 7. That all the members of the family made a contribution of partnership capital, which capital was represented by the liquidated assets of the predecessor corporation.

In fact, the parties gave every physical manifestation of their intention to form a limited partnership that could possibly be made, and the genuineness of their intention to form a limited partnership is apparent from the record. The record does not contain any evidence disputing the genuineness of their intention. If the test of intention is to be applied to this case, and the law is clear that it must, and if due consideration is to be given to the plain provisions of the 1943 limited partnership agreement and its background, and to the clearly established conduct of the partners "in execution of its provisions", the inevitable conclusion must be that the 1943 limited partnership was valid, binding and subsisting as to all the partners during the years 1943 and 1944. The intention of the partners in this case to become partners in the conduct of a lawful business is as plain as written words and the conduct of the parties can make it.

Petitioner feels that the *Tower* and *Lusthaus* cases and the other authorities cited carry only one mandate: Look at the record fairly and see what the parties intended.

If that is done in this case, the lower court must be reversed in its determination that petitioner's wife and children were not limited partners. For this record gives only one answer, that the business as a corporation and as a partnership, was always the venture of the Morano family; that the business became a success because all the members of the family gave unstintingly of their endeavor. The business had, in a way, always been a partnership in the sense that its success was the result of the joint efforts of the entire family. The record is a history of such a unified joint effort, each contributing a particular skill, and each giving his maximum to the venture. Petitioner knew better than anyone else that the business could not succeed without the constant encouragement and hard work of his family. For that reason he determined to provide the funds to acquire corporate stock for the family so that each could share in the ownership and profits of the business. He also desired to reward his family for their past services. It would have been surprising if he had not done so. When the gifts of the funds to procure the stock were made, the corporate profits were negligible. Further, it was realized that after the stock was acquired by the family, it would be up to the family to increase the financial worth of the business. The record shows that the motives prompting the gifts were legitimate and honest. The record further shows that the division of ownership in the business took place at the time the funds were provided by petitioner to procure the corporate stock, at which time the limited partnership was not even in contemplation. To ignore the prior history of the business as a corporation and the prior ownership thereof by the members of the family, is to distort the record and confound the law. The Tax Court's determination that petitioner's wife and children were not limited partners, has no basis in the record whatsoever and is in direct conflict with the law. This partner-

ship is an instance of a legitimate family partnership which is unfortunately caught in the backwash of a rigid and misconceived interpretation of the Tower opinion. The Tax Court in this case obviously misunderstood and misconstrued that opinion. If the *Tower* decision, properly interpreted, is applied by this Court to this record, the lower court must be reversed and a decision entered recognizing petitioner's wife and children as limited partners.

Point II

This Court, twelve days after the judgment was filed in this case, decided the case of *Commissioner* v. *Culbertson*, 337 U. S. 733. The *Culbertson* case set forth the same argument and reasoning as is contained in Point I of this brief. This argument was presented to the lower court in almost the identical language.[21]

This Court, in the *Culbertson* case, held that the Tax Court had applied the wrong tests and the wrong emphasis in reaching its conclusion that the members of the family did not really and truly intend to form a partnership. The Tax Court had read the decisions in *Commissioner* v. *Tower* and *Lusthaus* v. *Commissioner* as setting out two essential tests of partnership for income tax purposes; that each partner contribute to the partnership capital originating with him or vital services. This Court held, however, that the *Tower* case provides no support for such an approach. "We there said that the question whether the family partnership is real for income tax purposes depends upon:

> "Whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both. And their intention in this respect is a question of fact, to

[21] See Petitioner's Brief, U. S. Court of Appeals for the Third Circuit, No. 9844, pp. 23-28.

> be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' Drennen v. London Assurance Co., 113 U. S. 51, 56; Cox v. Hickman, 8 H. L. Gas. 268. We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. 372 U. S. at 287".

This court finally held that the Tax Court "ignores what we said is the ultimate question for decision, namely, 'whether the partnership is real within the meaning of the federal revenue laws' and makes decisive what we described as 'circumstances (to be taken) into consideration' in making that determination."

The opinion of the Tax Court in the present case resounds with the error, the misplaced emphasis, and the erroneous tests of partnership which are condemned by this Court in the *Culbertson* case. In the first paragraph of its opinion in this case (R. 128) the Tax Court held:

> "This is a family partnership case in which petitioner claims validity of the arrangement for tax purposes on the grounds that his wife and children contributed services and capital originating with them. Commissioner v. Tower, 327 U. S. 280; Lusthaus v. Commissioner, 327 U. S. 293."

This Court held, that the vice implicit in the erroneous tests adopted by the Tax Court is that it assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership.

The lower court attacked the contribution of the liquidated value of corporate stock by the members of the family in the present case and held that the contribution of capital did not originate with them. The Tax Court

examined the pedigree and antecedents of the corporate stock, and the transfers thereof, and found that petitioner had provided the funds for the transfer and assignment of this corporate stock from the original holders thereof to the members of the family.

In spite of the fact that this was accomplished almost one year before a partnership was contemplated, the Tax Court held that petitioner was the original source of the capital, as the same is defined by the *Tower* case.

It is respectfully submitted that the *Tower* case, as elucidated by the *Culbertson* case, provides no support whatsoever for so rigid an interpretation of the terms, "capital originating with them". It is true that petitioner caused the dissident stockholders to transfer their stock to the members of his family by providing the purchase price therefor. However, the purchase price which was the consideration for these transfers, was in turn based upon a consideration which transcended the law of contracts. Petitioner paid the purchase price for these transfers because of his love for the family, and in recognition of the services being performed by them. The Commissioner of Internal Revenue by his stipulation in open Court (R. 110) also realized the honesty of petitioner's motives.[22]

This Court held in the *Culbertson* case that the Tax Court's isolation of "original capital" as an essential of membership in a family partnership indicates an erroneous reading of the *Tower* opinion:

> "We did not say that the donee of an intra family gift could never become a partner through investment

[22] In *Durwood* v. *Commissioner*, 159 Fed. (2d) 400, the Court of Appeals for the Eighth Circuit, citing the Tax Court decision of *Alexander* v. *Commissioner*, 6 T.C. 804, made the distinction that when the wife received her interest in the partnership from one other than her husband, even though the husband had made it possible for her to secure the money with which to purchase the interest, the partnership would be recognized.

of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in Helvering v. Clifford, supra."

The *Culbertson* case sets up the criteria; who were the true owners of capital contributed to the partnership? The answer in the present case is beyond equivocation, especially as that term is defined in the Earl-Clifford-Horst line of cases,[23] and as the same was resolved in the *Culbertson* case.

Point III

The Commissioner of Internal Revenue and the Tax Court have adopted an arbitrariness of view, and a decided prejudice against the taxpayer in matters involving family partnerships. The Congressional attitude, as expressed by law and pending legislation does not sanction such an attitude. Nor do the decisions of this Court.

It is the over-zealousness of the Tax Court which has caused this departure from the legislative mandate. In the present case the Tax Court did not even feel compelled to follow the case of *Lawton* v. *Commissioner*, 164 Fed. (2d) 380, choosing instead to follow its own reversed decision. The review by the Court of Appeals was not proper in scope, in that it failed to recognize that the Tax Court proceeded on erroneous premises of law, and did not determine the ultimate fact of the case, or the "reality" of the ~~petitioner~~ partnership as a fact. The Tax Court used an erroneous rule of thumb[24] in setting aside the partnership in the present case.

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[23] *Lucas* v. *Earl*, 281 U. S. 111, *Helvering* v. *Clifford*, 309 U. S. 331, *Helvering* v. *Horst*, 311 U. S. 112.

[24] Shortly after the Tower and Lusthaus decisions, the proposition was squarely presented to the Court of Appeals for the Fifth Circuit in the case of *Thomas* v. *Feldman*, 158 F. (2d) 488 (1946). In that case the taxpayers had transferred to trusts, created by them for the benefit of their minor children, certain shares of stock in two family corporations. Sub-

It is a basic principle of income taxation that income derived from property is taxable to the bona fide owner of that property, whether such ownership was acquired by purchase or gift, and whether it was acquired from a stranger or a relative. The Supreme Court has never questioned this basic principle.

Upon what statutory basis or theory of income tax law is a transfer of a property interest to a partnership to be treated differently from any other transfer? It is fundamental in the law that a managing partner is no more free to use property as his own than is a managing trustee. Of course, it is always possible that a father—whether trustee, guardian, partner, or joint tenant—may misuse his position and treat as his own what belongs to a wife or child, and the chances are that he will not suffer the same consequences as if he were dealing with a stranger. But certainly there is no presumption that a father will so violate the law, and Congress has never endorsed any intention to treat the power to violate the law as divesting the interest, for tax purposes or otherwise, of the wife or child. And this consideration would no more justify ignoring the tax results which the statutes attach to partnership activity than the

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sequently the corporations dissolved and the assets thereof were distributed to the respective shareholders, who organized two limited partnerships. In each of these partnerships, one of the taxpayers was the general and managing partner, and the trusts and other shareholders were limited partners. The Court, with one judge dissenting, affirmed the District Court and held that partnership income allocated to the trusts was not taxable to the taxpayers. The Tower and Lusthaus decisions were distinguished on the ground that in each of those cases the Tax Court had made a finding that the wife was not a genuine partner. The Solicitor General did not petition for certiorari.

The acceptance of the interpretation adopted in the *Feldman* case, and a realization that the powers of Courts of Appeals are not so restricted as to prevent a reversal of the Tax Court where it has applied the incorrect rule of law which it had drawn from the *Tower* case, were deterrent factors in the Tax Court's attitude of wholesale slaughter of family partnerships.

statutory results attaching to activity involving other forms of property.

The latest expression on this subject was voiced by Circuit Judge Waller of the Fifth Circuit in his dissenting opinion in the case of *Ginsburg* v. *Commissioner,* CCH 49-2 U. S. T. C. ¶ 9381, which became the majority opinion on rehearing, CCH 49-2 U. S. T. C. ¶ 9396.

> "The power to tax is the power to destroy, if the courts instead of protecting against destruction, aid and abet it by putting into the law the weapons of death with instructions as to how to use them.
>
> Neither the common law, the statutes of Texas, nor the statutes of Congress ever fashioned the weapons for destroying bona fide father and son partnerships."

The petitioner respectfully urges that the decision of the Court of Appeals for the Third Circuit is in conflict with the established body of the law, and by its encroachment upon basic and accepted concepts of the law, will create an indeterminable confusion.

Respectfully submitted,

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APPENDIX

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME.

(a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1946 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1946 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U. S. C. 1946 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) Partnership and Partner.—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate, or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * * * *

(26 U. S. C. 1946 ed., Sec. 3797.)